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Date:  
July 19, 2007

Taxpayer =

Date 1 =

Date 2 =

Date 3 =

Dear \_\_\_\_\_:

This is in response to the Date 1 letter and subsequent submissions by Taxpayer requesting ruling concerning the issuance of deferred gift annuities and the application of section 72 of the Internal Revenue Code.<sup>1</sup>

### FACTS

Taxpayer represents that is a public charity within the meaning of section 509 of the Internal Revenue Code and is exempt from tax under section 501(c)(3). Taxpayer's principal activity is the translation, publication and distribution of Bibles in the language of the reader around the world. Taxpayer has issued charitable gift annuities since date 3 and continues to issue gift annuities, both immediate and deferred, to donors. Taxpayer follows recommended annuity rates issued by the American Council on Gift Annuities.

Taxpayer proposes to issue two special kinds of deferred gift annuities, known as flexible gift annuities (Contracts). The Contracts provide that the annuity commences at the time the donor elects to begin receiving the annuity. The Contracts set forth a target date for commencement of the annuity but not a specific date. In some cases, the Contracts provide that the donor must elect to commence receiving the annuity within a certain window. Whether or not the annuitant elects to begin receiving annuity payments on the target date, the annuity will be paid at an annuity rate that will produce

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<sup>1</sup> On Date 2, Taxpayer withdrew its ruling requests regarding sections 511-514 of the Code.

the same charitable deduction. In all cases, the annuity rates will be set by reference to an age-based schedule so that the actuarial value of the remainder will be the same regardless of when the donor elects to commence receiving the annuity.

The Contracts will be issued to cover no more than two lives. If a Contract is issued for two lives, the consent of both annuitants to the commencement of the annuity is required if both annuitants are living. The Contracts will not guarantee a minimum or specify a maximum number of payments.

Taxpayer requests a ruling that the donors who contribute cash or other property in exchange for the Contracts will not have constructive receipt of income until they begin receiving annuity payments.

## LAW

Section 72(a) provides that except as otherwise provided in Chapter 1 of the Code, gross income includes any amount received as an annuity (whether for a period certain or during one or more lives) under an annuity, endowment, or life insurance contract.

Section 72(b)(1) provides, in general, that gross income does not include that part of any amount received as an annuity under an annuity, endowment, or life insurance contract which bears the same ratio to such amount as the investment in the contract (as of the annuity starting date (ASD)) bears to the expected return under the contract (as of such date).

Section 72(b)(2) provides that the portion of any amount received as an annuity which is excluded from gross income under section 72(b)(1) shall not exceed the unrecovered investment in the contract immediately before the receipt of such amount.

Section 72(c)(4) provides, generally, for purposes of section 72, that the ASD in the case of any contract is the first day of the first period for which an amount is received as an annuity under the contract.

Treas. Reg. section 1.72-4(b)(1) provides, generally, that the first day of the first period for which an amount is received as an annuity under the contract is the later of (i) the date upon which the obligations under the contract become fixed or (ii) the first day of the period which ends on the date of the first annuity payment.

Treas. Reg. section 1.72-2(b)(2) provides that amounts subject to section 72 are considered "amounts received as an annuity" only in the event that all of the following tests are met:

(i) The amounts must be received on or after the "annuity starting date" as that term is defined in Treas. Reg. section 1.72-4(b);

(ii) The amounts must be payable in periodic installments at regular intervals (whether annually, semiannually, quarterly, monthly, weekly, or otherwise) over a period of more than one full year from the ASD; and

(iii) Except as indicated in Treas. Reg. section 1.72-2(b)(3), the total of the amounts payable must be determinable at the ASD either directly from the terms of the contract or indirectly by the use of either mortality tables or compound interest computations, or both, in conjunction with such terms and in accordance with sound actuarial theory.

Treas. Reg. section 1.72-2(b)(3) provides that, notwithstanding the requirement of Treas. Reg. section 1.72-2(b)(2)(iii), if amounts are to be received for a definite or determinable time (whether for a period certain or for a life or lives) under a contract which provides that the amount of the periodic payments may vary with investment experience, then each such payment received shall be considered as an amount received as an annuity only to the extent that it does not exceed the amount computed by dividing the investment in the contract, as adjusted for any refund feature, by the number of periodic payments anticipated during the time periodic payments are to be made. If payments are to be made more frequently than annually, the amount so computed shall be multiplied by the number of periodic payments to be made during the taxable year for the purpose of determining the total amount which may be considered received as an annuity during such year. To this extent, the payments received shall be considered to represent a return of premiums or other consideration paid and shall be excludable from gross income in the taxable year in which received. To the extent that the payments received under the contract during the taxable year exceed the total amount thus considered to be received as an annuity during such year, they shall be considered to be amounts not received as an annuity and shall be included in the gross income of the recipient.

Section 72(e)(1)(A) provides, in general, that section 72(e) shall apply to any amount that is received under an annuity contract and is not received as an annuity if no provision of the income tax law (other than section 72(e)) applies with respect to such amount.

Section 72(e)(2)(A) provides that any amount to which section 72(e) applies, if received on or after the ASD, shall be included in gross income.

Section 72(e)(5)(E) provides that this rule shall not apply, however, to (i) any amount received, whether in a single sum or otherwise under a contract in full discharge of the obligation under the contract which is in the nature of a refund of the consideration paid for the contract; and (ii) any amount received under a contract on its complete surrender, redemption, or maturity. In these circumstances, the amount received shall be included in gross income, but only to the extent it exceeds the investment in the contract.

Section 72(e)(2)(B) provides, as a general rule, that any amount to which section 72(e) applies if received before the ASD --

- (i) shall be included in gross income to the extent allocable to income on the contract, and

- (ii) shall not be included in gross income to the extent allocable to the investment on the contract.

Section 72(s)(1)(B) provides, generally, that a contract will not be treated as an annuity contract for purposes of the Code unless it provides that if any holder of such contract dies before the ASD, the entire interest in such contract will be distributed within 5 years after the death of such holder.

Section 72(s)(2) provides an exception for certain amounts payable over the life of a designated beneficiary. Specifically, section 72(s)(2) provides that if:

- (A) any portion of the holder's interest is payable to (or for the benefit of) a designated beneficiary,

- (B) such portion will be distributed (in accordance with regulations) over the life of such designated beneficiary (or over a period not extending beyond the life expectancy of such beneficiary), and

- (C) such distributions begin not later than 1 year after the date of the holder's death or such later date as the Secretary may by regulations prescribe,

then, for purposes of section 72(s)(1), the portion referred to in section 72(s)(2)(A) shall be treated as distributed on the day on which such distributions begin.

Treas. Reg. section 1.451-1(a) provides that gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting.

Treas. Reg. section 1.451-2(a) provides that income, although not actually reduced to a taxpayer's possession, is constructively received by the taxpayer in the taxable year that it is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it any time, or so that the taxpayer could have drawn upon it during the taxable year if notice of intention to withdraw had been

given. However, the regulation provides that income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

## ANALYSIS

An annuity contract consists of an accumulation phase and a phase subsequent to the ASD, commonly referred to as annuitization. During the accumulation phase, all amounts received by the holder are "amounts not received as an annuity." During the annuitization phase, if the requirements of Treas. Reg. section 1.72-2(b)(2) and (3) are met, amounts received by the holder may be characterized as "amounts received as an annuity." During the annuitization phase, amounts received by the holder may, in certain circumstances, be characterized as "amounts not received as an annuity." See section 72(e)(2)(A) and Treas. Reg. section 1.72-2(b)(3)(i). Regardless of the characterization of the payments made as "amounts received as an annuity" or "amounts not received as an annuity," no amount should be considered constructively received by an annuitant before its actual payment under the proposed distribution methods for several reasons.

First, section 72 provides a comprehensive scheme for the taxation of life insurance, endowment, and annuity contracts. Section 72(a) and (b) provide, in general, for the taxation of "amounts received as an annuity." Section 72(e), in general, taxes amounts received under life, endowment, and annuity contracts that are "not received as annuities."

Both section 72(a) and (e) literally require that amounts be "received" by the holder before they are included in gross income. The statute is silent as to whether amounts that are only "constructively received," within the meaning of Treas. Reg. section 1.451-2(a), are "received" under section 72 and includible in gross income in accordance with the provisions of section 72.

Second, prior to the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), 1982-2 C.B. 462, "amounts not received as an annuity" that were paid out before the ASD were includible in the holder's gross income only after the holder recovered the holder's investment in the contract. The Conference Committee Report to TEFRA explained the law prior to the statutory changes as follows:

Under present law, taxation of interest or other current earnings on a policyholder's investment in an annuity contract generally is deferred until annuity payments are received or amounts characterized as income are withdrawn. Amounts paid out before the annuity starting date are first a return of capital and are taxable (as ordinary income) only after the investment in the contract is recovered.

H.R. Conf. Rep. No. 760, 97th Cong., 2d Sess. 646-47 (1982), 1982-2 C.B. 600, 685.

The Conference Committee generally followed the Senate amendment, which it described in the following terms:

The Senate amendment provides that amounts received before the annuity starting date will be treated first as withdrawals of income earned on investments to the extent of such income, the remainder being treated as a return of capital. Likewise, loans under the contract, or amounts received upon assignment or pledging of the contract, will be treated as amounts received under the contract. These provisions apply as of July 1, 1982, but do not apply to amounts allocable to investments made before July 2, 1982, to endowment or life insurance contracts (except to the extent prescribed in regulations), or to contracts purchased under qualified plans.

H.R. Conf. Rep. No. 760 at 647, 1982-2 C.B. at 685. Thus, the TEFRA changes to section 72 do not indicate that Congress intended to change prior law, which did not apply the doctrine of constructive receipt to annuity contracts.

Third, section 72(e)(4)(A), which provides generally that if an individual receives a loan under an annuity contract or pledges a portion of the value of such contract, the amount of the loan or the portion of the value pledged will be treated as an amount not received as an annuity, is inconsistent with applying the doctrine of constructive receipt to annuities. If the doctrine of constructive receipt applied, the increase in the annuity's cash value would be taxed once and would in many cases be subject to tax a second time as an amount not received as an annuity under section 72(e)(2), a result inconsistent with general income tax principles.

Fourth, the provisions of section 264(a) disallowing deductions on indebtedness to purchase or carry certain annuities further support our conclusion that the doctrine of constructive receipt does not apply to annuities. In fact, section 264(a)(3) generally disallows a deduction for any amount paid or accrued on indebtedness incurred or continued to purchase an annuity contract pursuant to a plan of purchase, contemplating the systematic borrowing of part or all of the increases in cash value of the contract. If such increases in cash value were taxable under the doctrine of constructive receipt there would be no abuse for section 264 to correct.

Fifth, neither does section 72(u) operate to require the designated beneficiary to include amounts in gross income prior to actual receipt. Section 72(u) only requires, prior to actual receipt, the recognition of the income on the contract, in certain cases in which the annuity contract is held by certain nonnatural persons. As defined in section 72(s)(4), for purposes of section 72(s), the term "designated beneficiary" means any individual designated a beneficiary by the holder of the contract.

## CONCLUSION

Where payments are made to an annuitant in accordance with section 72 and Treas. Reg. section 1.72, no amount will be constructively received by the annuitant until the annuitant actually begins receiving payments.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter including but not limited to whether or not the Contracts constitute annuities pursuant to section 72 or any other provision of subchapter L and whether a tax may be owed on the exchange of appreciated property for a private annuity.

This ruling is directed only to Taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, for a return(s) filed electronically, this requirement is satisfied by attaching a statement to the return(s) that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Sheryl B. Flum  
Sheryl B. Flum  
Chief, Branch 4  
Office of Associate Chief Counsel  
(Financial Institutions & Products)